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Uniform Rules of Engagement: The New Tax Regime for Foreign Sales

BY HAROLD S. PECKRON *

Nine-tenths of the serious controversies which arise in life result from misunderstandings; result from one man not knowing the facts which to the other man seem important, or otherwise failing to appreciate his point of view.

Justice Louis D. Brandeis¹

Introduction

Justice Brandeis' comment aptly illustrates the area of foreign trade concessions granted by one government to its corporate citizens as interpreted by the world community. Misunderstandings and a failure to appreciate the other country's point of view can lead to disastrous consequences, indeed, even to war.

To reduce the likelihood of such occurrences, uniform rules of engagement have been adopted much like the uniform rules of engagement in military warfare. The latter rules presume consistent treatment of combatants in an armed conflict as customarily recognized in international law.² It strengthens the moral claim of the international community because it emphasizes their humanitarian

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1. See THE FORBES BOOK OF BUSINESS QUOTATIONS 848 (Edward C. Goodman & Ted Goodman eds., 1997).

2. Convention for the Amelioration of the Condition of the Wounded and Sick in Armed Forces in the Field (Geneva Convention No. I), Aug. 12, 1949, 6 U.S.T. 3114, 75 U.N.T.S. 31. See also Theodor Meron, *The Geneva Conventions as Customary Law*, 81 AM. J. INT'L L. 348 (1987).

underpinnings.³ The United States has codified the uniform rules of engagement, as expressed in international agreements, which recognize military principles of necessity, proportionality, and the moral rule of mitigation of suffering.⁴ Thus, uniform rules of engagement are the detailed instructions issued by military authorities to specify binding limits on combat operations.⁵

So it is in the foreign trade arena. The World Trade Organization (WTO), the successor to the General Agreement on Tariffs and Trade (GATT), administers, enforces, and decides international trade disputes by establishing uniform rules of trade engagement designed to minimize trade wars through a moral rule of mitigation of economic suffering by a member.⁶

Countries that fail to abide by the WTO uniform rules of trade engagement can be taken to the WTO courts and face eventual sanctioned retaliation.⁷ Without such rules, global economic competition can become as fierce as the most devastating battle and, as history has shown, can be the catalyst for a world war.⁸ Consider that if last ditch trade negotiations being conducted by Japanese envoys in Washington had succeeded, orders would have been sent to Admiral Nagumo to return the invasion force heading toward Hawaii.⁹ Foreign trade, even today, results in brutal consequences to trading partners who, to paraphrase Justice Brandeis, "fail to appreciate the other person's (country's) point of view" and, thus, fail

3. Meron, *supra* note 2, at 350.

4. See U.S. Dept. of the Army, *The Law of Land Warfare* 6, Field Manual No. 27-10 (1956).

5. See, e.g., EDWARD LUTTWAK & STUART L. KOEHL, *THE DICTIONARY OF MODERN WAR* 494 (1991). In modern times, rules of engagement have become an inevitable aspect of all military operations. Given the potential political consequences of any military action, and the prevalence of ambiguous situations in the nuclear era, the tension between political control and military expediency will likely remain unresolved. *Id.*

6. See *The WTO in Brief*, Part I, at <http://www.wto.org> (last visited Jan. 21, 2002).

7. See *In Focus: WTO and Developing Countries*, at <http://www.foreignpolicy-infocus.org> (last visited Jan. 21, 2002).

8. The "silent embargo" on Japan during the Roosevelt administration froze all of Tokyo's assets in the United States, requiring the Japanese to obtain a license for any product deemed useful to their war machine and yet another license to unfreeze the dollars to pay for it. This meant they had to go to both the State Department and the Treasury Department, leaving ample room for maximum bureaucratic foot dragging. See THOMAS FLEMING, *THE NEW DEALERS' WAR: FDR AND THE WAR WITHIN WORLD WAR II*, at 18 (2001).

9. See WALTER LORD, *DAY OF INFAMY* 18 (1985).

to respect the international uniform rules of trade engagement in trade pacts administered by the WTO.¹⁰

The purpose of this Article is to examine the recent foray of the United States into the alleged disregard of the uniform trade rules through the use of foreign sales corporations and how this latter tax regime almost ignited an international trade war.¹¹ To fully comprehend the magnitude of this potential trade war, with its significant political and tax consequences, the demise of foreign sales corporations, its new substitute on the international tax stage, and the concomitant policy implications will be examined. Before the death knell for foreign sales corporations is heralded, however, a historical perspective needs to be gained.

I. A Historical Perspective

A. *International Tax Competition*

The world of today is truly shrinking. Trade barriers are evaporating, capital flows recognize no boundaries, and the Internet makes worldwide communication a reality.¹² Hence, isolationist policies are somewhat anecdotal. This emerging global trade environment creates a challenging tax atmosphere for countries seeking to establish national tax policies based upon fairness and neutrality while harmonization critics contend that “fairness” in tax policy must be seen through an international prism.¹³

10. See, e.g., United States – Tax Treatment for “Foreign Sales Corporations,” WTO Doc. WT/DS108/AB/R (Feb. 24, 2000), available at <http://www.wto.org> (last visited Dec. 1, 2001), reprinted in 2000 WTO DS LEXIS 7 [hereinafter Appellate Panel Report]. Reports issued under the WTO’s dispute settlement procedures are available online at <http://www.wto.org>.

11. For an interesting topical description of this potential trade “war,” see *This Tax Break Could Trigger a Trade War*, BUS. WEEK, Sept. 4, 2000, at 103.

12. See Jonathan Talisman, *Challenges for Tax Policy in a Global Economy*, Remarks to the IRS/GW Annual Institute on Current Issues in International Taxation, TAX NOTES TODAY, Dec. 11, 2000, at 1, available at 2000 TNT 238-70.

13. Harmonization of tax policy, like accounting standards, on an international basis recognizes that little may be gained by sacrificing American tax policy objectives of fairness and neutrality. *Id.* at 2. See also DAVID SOLOMONS, MAKING ACCOUNTING POLICY: THE QUEST FOR CREDIBILITY IN FINANCIAL REPORTING 62 (1986). Evident in this policy is the taxation of income earned by foreign corporations outside the United States. Such income is generally taxed only if it is “effectively connected with the conduct of a trade or business within the United States” as provided under I.R.C. § 882(a). And the anti-deferral tax treatment, set

This tension breeds tax competition. While the divas may sing that “love makes the world go round,” in reality it is capital that makes the world turn on its axis, and there is no better means to attract capital to one’s shores than with a favorable tax policy. Tax havens¹⁴ are countries in the international community with tax regimes designed to attract capital by allowing nonresident individuals and corporations to receive preferential tax treatment on their capital while ensuring their absolute secrecy from any government. Such tax regimes violate the test of fairness in international tax competition. As stated by the Treasury Assistant Secretary for Tax Policy:

There has been significant confusion regarding the distinction between fair and unfair tax competition. This confusion has been fueled by certain opponents of the OECD’s harmful tax competition initiative, who have mischaracterized the efforts as attempts to establish high tax cartels and establish minimum levels of taxation across the globe. Let me be clear: Countries are free to choose the method and rate of taxation appropriate to fund their public sectors. However, countries have gone beyond that right when they have regimes that lack transparency, that are “ring fenced” or shielded from their own economies and core tax base or with respect to which there is no information exchange. Tax systems with those features erode other countries’ tax bases and infringe on their ability to implement their own tax policy decisions. Thus, the work at the OECD is limited to regimes with these harmful features—lack of transparency, lack of information exchange, or discrimination between residents and nonresidents—in especially mobile sectors of the economy, and thus is narrowly targeted at the problem of harmful tax competition.¹⁵

In light of this identification of an unfair international tax regime

forth at Subpart F of the Internal Revenue Code, which imputes to the U.S. parent corporation the non-repatriated income of its foreign subsidiary, posits yet another basis for tax policy fairness and neutrality.

14. A tax haven is any country that has a low or zero rate of tax on all or certain categories of income, and offers a certain amount of banking or commercial secrecy. There are technically three forms of tax havens: countries that treat residents and nonresidents alike by imposing a zero rate of tax on all income; countries that treat nonresidents differently by imposing local income tax but no foreign tax on foreign source income or profits; and countries that grant special privileges to nonresidents by imposing a lower rate of tax. See HOYT L. BARBER, *TAX HAVENS: HOW TO BANK, INVEST, AND DO BUSINESS – OFFSHORE AND TAX FREE* 4 (1992). See also JOSEPH ISENBURG, *INTERNATIONAL TAXATION* 3-7 (2000).

15. Talisman, *supra* note 12, at 2.

as containing indicia of lack of transparency, lack of information exchange, and discrimination between residents and nonresidents, how did the United States foreign sales corporations reach this point in world opinion? It was *not* the first time that the international community found the United States practicing unfair international tax competition. The first such attempt was the Domestic International Sales Corporation (DISC).

B. Domestic International Sales Corporations (1971)

In the Revenue Act of 1971 a new tax regime was created, known as the domestic international sales corporation or DISC.¹⁶ Prior to this time, United States-based manufacturing companies would establish foreign sales subsidiaries in zero or low tax countries (tax havens) and substantially reduce their U.S. tax liability by altering the price, cost, and ultimate profit allocations between the United States-based manufacturing company and the foreign-based sales subsidiary. To somewhat control these recalcitrant companies, Congress passed Subpart F¹⁷ of the 1954 Internal Revenue Code and the Treasury enacted the I.R.C. § 482 regulations.¹⁸

The gist of the Subpart F and § 482 regulations was, to many U.S. corporations doing business overseas, worsening an already growing unfavorable balance of trade.¹⁹ This politically unpalatable outcome of increasing trade deficits motivated Congress to enact the DISC provisions. To become a “DISC,” it was no longer permissible to have a foreign sales subsidiary as every DISC had to be a U.S. corporation included in the U.S. parent corporation’s consolidated tax return.²⁰ DISC treatment was elective in nature²¹ and required its

16. Revenue Act of 1971, Pub. L. No. 92-178, tit. V, 85 Stat. 497 (1971). The DISC provision had been introduced earlier in the Trade Act of 1970 but was not enacted. See H.R. 18970, 91st Cong., 2d Sess. (1970).

17. Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960 (1962).

18. T.D. 6952, 1968-1 C.B. 218.

19. See HOUSE COMM. ON WAYS AND MEANS, 91ST CONG., 2D SESS., PROPOSAL OF THE U.S. TREASURY DEPARTMENT (Comm. Print 1970).

20. See I.R.C. § 992. Despite the fact that DISCs became inoperative in 1984, the DISC provisions in the 1954 Code were carried over to the 1986 Code as cited hereunder. This was an ingenious “back door” approach to ensuring that the Treasury and its IRS would have access to the books and records of DISCs, and that the DISCs would adopt U.S. generally accepted accounting principles. See Edwin S. Cohen & Michael D. Hankin, *A Decade of DISC: Genesis and Analysis*, 2 VA. TAX REV. 7 (1982).

21. All code section references hereunder are to the Internal Revenue Code of

income to be export generated.²² Any "qualified" export property (e.g. products) had to be produced in compliance with a 50% domestic content rule,²³ thereby ensuring no migration of U.S. jobs.

The purpose of this new tax regime was to allow the United States-based DISC to receive tax *deferral*²⁴ (not forgiveness) on its export earnings. The U.S. parent corporation would be subject to tax on the DISC earnings,²⁵ on a consolidated basis,²⁶ albeit foreign tax credits would prevent any double taxation. The schema for profit allocation between the DISC and its parent substantially lessened the complexity of the Section 482 regulations.²⁷ Ultimately, the buy back of foreign sales corporations by allowing tax deferral of U.S. based sales corporations did improve the balance of trade.²⁸ And such was its Achilles heel.

The world community branded the DISC provisions as naked trade exploitation, granting a prohibited export subsidy to U.S. companies in violation of the uniform rules of trade engagements pursuant to GATT.²⁹

Belgium, France and The Netherlands commenced a GATT proceeding positing that the export subsidy granted under the DISC provisions resulted in bilevel pricing,³⁰ i.e., export prices lower than domestic prices causing immediate harm to trading partners.³¹ The United States contended, inter alia, that the complaining parties offered their exporters dividend income exemptions received from

1986. See I.R.C. § 992.

22. *Id.*

23. I.R.C. § 993.

24. I.R.C. § 991.

25. I.R.C. § 995.

26. This includes any deemed dividend payments. *Id.*

27. Companies could opt for one of three transfer pricing methods to allocate profits. To wit:

1. Section 482 pricing and the regulations thereunder;
2. Proportional (50/50) allocation of the combined taxable income; or
3. Nonproportional (4/96) allocation of the DISC's gross receipts from export transactions and the U.S. parent, respectively.

See I.R.C. § 994.

28. See John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. 747 (1978).

29. *Id.*

30. *Id.*

31. The European Economic Community (later the European Union) supported the countries attacking the DISC regime as unfair tax competition characterized as an export subsidy. *Id.*

foreign subsidiaries.³²

Simultaneous with the GATT hearings on this matter, the Tokyo Round of Multilateral Trade Negotiations were being conducted wherein an addendum to the Subsidies Code (Article XVI(4)) characterized a subsidy as “the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.”³³ Shortly thereafter, the GATT Council adopted the conclusions of GATT investigative panels which had heard the cases and determined that the tax systems of the United States, France, Belgium and The Netherlands had unfairly violated the uniform trade rules set forth under GATT.³⁴ Since adoption was precluded without the unanimous consent of the contracting parties, final adoption was delayed until 1981 at which time the GATT Council promulgated the following ruling with all parties in agreement (known as the “Understanding”):

The Council adopts these reports on the understanding with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI: 4 of the General Agreement. It is further understood that Article XVI: 4 requires that *arms-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arms-length*. Furthermore, Article XVI: 4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.³⁵

32. See Tax Legislation Cases: Income Tax Practices Maintained by France, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 121 (1977); Income Tax Practices Maintained by Belgium, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 132-33 (1977); Income Tax Practices Maintained by The Netherlands, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 142-43 (1977).

33. GATT Subsidies Code Annex para. (e). See GATT Doc. No. MTN/NTM/W 236 (1979).

34. See United States Tax Legislation Case (DISC), Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 98, 112-14 (1977); *Income Tax Practices Maintained by France*, at 114, 125-27; *Income Tax Practices Maintained by Belgium*, at 127, 134-36; *Income Tax Practices Maintained by The Netherlands*, at 137, 145-47.

35. See *DISCs: US-Europe Tax Pact Finally Accepted by GATT Council*, Daily Tax Rep. (BNA), at 1 (Dec. 9, 1981) [hereinafter *Tax Pact*] (emphasis added).

As a result of the 1981 Understanding, the United States needed a new tax regime for income earned in foreign countries by its residents. The Reagan administration's trade policy initiatives did not include "patching" the DISC provisions, which would have exacerbated a bad situation by making it worse.³⁶ Such a policy could have served to further alienate existing trading partners. So, an entirely fresh approach in tax policy was needed to conform to the political realities of the approaching mid-1980s. That reality became Foreign Sales Corporations.

C. Foreign Sales Corporations (1984)

The problem for the Treasury and Congress was to design a tax regime that did not run afoul of the world community by creating an illegal export tax subsidy for U.S. corporations. Despite American denials, the GATT Council had found U.S. policy to be such a violation of GATT rules,³⁷ making the tax deferral mechanisms of DISCs a less than reliable approach.

As any good architect, the Treasury designed a plan using the actual GATT Council's unanimous understanding of the five parties,³⁸ which led it to suggest to Congress the tax regime known as foreign sales corporation (FSC). Adopted by Congress in the Deficit Reduction Act of 1984,³⁹ FSCs were designed to mitigate the debilities associated with DISCs. In a nutshell, FSCs scrap the tax deferral mechanism of DISCs for one of tax exemption, adopting a territorial application⁴⁰ set forth in the understanding.⁴¹

The primary distinction of the FSC versus DISC derived from the Understanding, which mandated that income be earned extra-territorially.⁴² Hence FSCs had to be *foreign* corporations subject to a foreign management process⁴³ unlike DISCs, which were domestic

36. See Jackson, *supra* note 28, at 779.

37. See *supra* note 34.

38. *Id.*

39. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 801(a), 98 Stat. 494, 985-1003 (1984). The DISC provisions were not repealed by the 1984 Act and the Treasury provided specific transition rules for DISCs and FSCs. See T.D. 7983, 1984-2 C.B. 151.

40. This territorial exclusion tax principle has been used in § 911 where a *limited* exclusion of foreign income is provided U.S. citizens in foreign countries. See I.R.C. § 911(a).

41. See *Tax Pact*, *supra* note 35.

42. *Id.*

43. See I.R.C. § 924(c).

corporations that had no tangible foreign nexus other than being a collection of foreign sales.⁴⁴ As described by the Treasury Department,⁴⁵ the differences between the FSC and DISC tax regimes are as follows:

A DISC is a domestic corporation which is not itself taxable while a FSC must be created or organized under the laws of a jurisdiction which is outside of the United States (including certain U.S. possessions) and may be taxable on its income except for its exempt foreign trade income. The DISC provisions enable a shareholder to obtain a partial deferral of tax on income from export sales and certain services, if 95 % of its receipts and assets are export related. The FSC provisions contain no assets test, but a portion of income for export sales and certain services is exempt from U.S. taxes if the FSC satisfies certain foreign presence, foreign management, and foreign economic processes tests.⁴⁶

Through the FSC device, the Treasury developed a taxing regime that walked the narrow gangplank between the GATT rules and the Understanding on the one hand, and the unfair international tax regime of tax haven creation on the other.⁴⁷

To facilitate the latter, FSCs could be incorporated only in those foreign countries that complied with a free exchange of tax information.⁴⁸

For a foreign corporation to qualify as an FSC, eight general statutory requirements⁴⁹ must be met. The eight conjunctive

44. *See supra* note 20.

45. Treas. Reg. § 1.921-2(c), Q&A 6.

46. *Id.*

47. *See* I.R.C. §§ 922, 927 (e)(3).

48. Not all jurisdictions in the European Economic Community initially qualified, albeit some did create special tax incentives to entice their establishment. *See, e.g., Symposium on Compelling Discovery and Disclosure in Transnational Litigation*, 16 N.Y.U. J. INT'L L. & POL. 957 (1984); Liebman, *Update on FSCs, With Particular Emphasis On the Use Of European Jurisdictions*, 67 TAXES 555 (1989).

49. *See* I.R.C. § 922(a). These eight general statutory requirements contain, in actuality, ten specific threshold requirements for qualification as set forth at the Treasury Regulations. *See* Treas. Reg. §§ 1.921-2(a), 1.922-1(a).

In addition, three exemptions are evident in the FSC tax regime. First is the exempt treatment of foreign trade income of the FSC as being *not* effectively connected with the conduct of a U.S. trade or business as required under I.R.C. § 882(a). Second is the exemption of Subpart F income earned by the FSC and not repatriated or distributed to the U.S. parent corporation. Last is the exemption of the FSC's foreign trade income distributed to the U.S. parent corporation as a dividend by allowing for a 100% dividends-received deduction.

requirements are set forth at § 922(a):

1. The FSC⁵⁰ must be a corporation, other than an insurance company, organized and recognized in a qualifying country or a U.S. possession⁵¹ other than Puerto Rico;⁵²
2. An FSC is limited to twenty-five shareholders.⁵³ This is defined as an individual,⁵⁴ corporate⁵⁵ or other⁵⁶ shareholder;
3. A blanket prohibition against the issuance of any preferred equity either outstanding or at any time.⁵⁷ This prohibition does *not* deny the FSC from issuing more than one class of common

50. There are technically four types of FSCs: regular FSC (recommended for foreign corporations with annual export sales beyond \$1 million because of the organization and maintenance costs); shared FSC (recommended for foreign corporations that wish to share the costs—and benefits—with up to twenty-five total exporters); small FSC (statutorily defined as a foreign sales corporation with exempt foreign trade income from foreign trading gross receipts of \$5 million or less in the taxable year as provided under § 924(b)(2)(B)(i)); and shared small FSCs (similar to the shared FSC only with the five million or less limitation up to twenty-five total exporters). *See* I.R.C. § 922(a)(1)(A); Treas. Reg. § 1.922-1(c).

51. I.R.C. § 922(a)(1)(A).

52. Puerto Rico is excluded from the four eligible U.S. possessions (American Samoa, Commonwealth of Northern Mariana Islands, Guam, and the Virgin Islands of the United States) but its products may be exported by using an FSC. *See* I.R.C. § 927(d)(3)(1986); Treas. Regs. § 1.922-1(d), (e), Q&A 5; *see also* I.R. Notice 84-15, 1984-2 C.B. 474 (providing the original list of twenty-five countries approved for FSC qualification purposes).

53. I.R.C. § 922(a)(1)(B).

54. Treas. Reg. § 1.922-1(f). Joint owners are counted individually. Thus, a husband and wife jointly owning the stock of one FSC would be treated as two shareholders toward the twenty-five shareholders rule. *See* Treas. Reg. § 1.922-1(f), Q&A 6(i).

55. Treas. Reg. § 1.922-1(f).

56. "Other" shareholders is generally interpreted to mean flow through entities, e.g., estates, trusts and partnerships (S corporations are specifically denied ownership in wholly-owned foreign entities as a qualified Subchapter S subsidiary must meet the general qualifications of S corporations denying it FSC status (as it did for DISCs). *See* I.R.C. §§ 1362(b)(2), 1361(b)(3)(B)). However, assuming *arguendo*, that an S corporation owned some ownership in an FSC, it would not receive the dividends-received deduction making the tax exempt FSC earnings taxable upon distribution.

An estate is treated as a single shareholder pursuant to Treas. Reg. § 1.922-1(f). A trust, on the other hand, is not treated as a shareholder, unless it is a grantor trust under I.R.C. §§ 671-679, in which case each grantor is treated as a shareholder; in non-grantor trusts the beneficiaries are treated as individual shareholders. *See* Treas. Reg. § 1.922-1(f), Q&A 6(iv). Each partner (general or limited) is treated as an individual shareholder similar to the trust treatment of its grantors or beneficiaries. *See* Treas. Reg. § 1.922-1(f), Q&A 6(v).

57. I.R.C. § 922(a)(1)(C).

- equity⁵⁸ unless such issuance is the intentional avoidance of federal income tax, e.g., directing dividends to shareholders with net operating loss carryovers;⁵⁹
4. The FSC must maintain its office, again within the concept of the foreign management process, within a qualifying jurisdiction,⁶⁰ albeit such office need not be within the qualifying country of incorporation;⁶¹
 5. To ensure the “foreign management process,” at least one member of the FSC Board of Directors must be a nonresident of the United States, citizen or not;⁶²
 6. The FSC must maintain its books and records at *both* its foreign office and in the United States.⁶³ “Books and records” is interpreted by the Treasury Department in the broadest possible sense including the FSC’s financials, invoices, statements of account, etc.⁶⁴
 7. If a controlled group of corporations⁶⁵ contain a regular FSC, then a DISC or “small” FSC is expressly excluded from such group.⁶⁶ A “small” FSC is any regular FSC with exempt foreign trade income from foreign trading gross receipts of \$5 million or less in the taxable year as provided under § 924(b)(2)(B)(i); and
 8. The FSC is only an FSC if a valid election is made by the foreign corporation in a timely fashion.⁶⁷ Timely fashion generally means ninety days prior to the beginning of the foreign corporation’s taxable year.⁶⁸

58. Treas. Reg. § 1.922-1(g).

59. *Id.* at Q&A 8.

60. I.R.C. § 922(a)(1)(D)(i).

61. *See* Treas. Reg. § 1.922-1(h), Q&A 11.

62. I.R.C. § 922 (a)(1)(E)(1986). *See also* Treas. Reg. § 1.922-1(j).

63. I.R.C. § 922(a)(1)(D)(ii).

64. *See* Treas. Reg. § 1.922-1(i), Q&A 12(i), (ii). *See also* Rev. Rul. 71-20, 1971-1 C.B. 392 (discussing acceptable forms of business records, e.g., electronic versus hard copy form).

65. “Controlled group of corporations” means the same as under the affiliated definition of I.R.C. § 1563(a) except that the operative percentage of control is reduced to more than 50% from less than 80%. *See* IRC § 927(d)(4)(1986).

66. I.R.C. § 922(a)(1)(F). *Compare* Treas. Reg. § 1.927(f)-1(a), Q&A 8 *with* Treas. Reg. § 1.924(a)-1T(j)(2) (stating that the existence of several small FSCs in a controlled group of corporations is permissible provided that the five million limitation is allocated among such small FSCs).

67. I.R.C. § 922(a)(2). *See* I.R.C. § 927(f) (discussing election of either a regular FSC or a small FSC).

68. I.R.C. § 927(f). But if the foreign corporation is electing FSC status in its

Once the foreign corporation meets the conjunctive requirements of § 922 and is treated as an FSC, it must qualify the export sales for FSC purposes under the foreign management and economic process requirements.⁶⁹ As with the requirements to qualify the foreign corporation as an FSC, the foreign management process⁷⁰ and foreign economic process⁷¹ are statutory conjunctive requirements that render the tax benefit of FSC treatment to qualified export sales by the FSC.

To satisfy the foreign management process requirement, three criteria must be met. First, any formal meetings of the FSC's board or shareholders must be outside the United States.⁷² Second, the principal bank account of the FSC must be maintained in a qualifying country.⁷³ Finally, all dividend, legal, accounting and administrative disbursements must be from the principal bank account.⁷⁴

In conjunction with the foreign management process, the FSC must meet the foreign economic process requirements⁷⁵ consisting of two tests. One test deals with sales participation activities⁷⁶ and the other test focuses on foreign direct cost activities.⁷⁷ Sales participation activities ensure that non-advertising solicitation and contract negotiation relate to a qualified transaction for generating foreign trading gross receipts.⁷⁸ Direct cost activities, set forth at § 924(e), include advertising and sales promotion, processing of orders and delivery, transportation, statement of account and receipt of

inaugural (first) year, then the ninety day window is opened wider to include ninety days *after* the beginning of its taxable year. *See* Treas. Reg. § 1.921-1T(b)(1), (2).

69. I.R.C. § 924(b)(1).

70. I.R.C. § 924(b)(1)(A).

71. I.R.C. § 924(b), (c), (d).

72. I.R.C. § 924(c)(1). *See also* Treas. Reg. § 1.924 (c)-1(b).

73. I.R.C. § 924 (c)(2). *See also* Treas. Reg. § 1.924(c)-1(c)(1). While a demand deposit (checking) account need be maintained, the regulations do not require that it be a negotiable order of withdrawal account or contain a specified balance. Thus, a non-interest bearing minimum or low balance demand deposit account satisfies this requirement. *See* Treas. Reg. § 1.924(c)-1(c)(1).

74. I.R.C. § 924(c)(3). No prohibitions exist on more frequent disbursements to minimize any foreign interest on the principal bank account and its adverse concomitant tax consequence. *See* Treas. Reg. § 1.924 (c)-1(d)(1).

75. *See* I.R.C. § 924(b), (c), (d).

76. I.R.C. § 924(d)(1)(A). *See also* Treas. Reg. § 1.924(d)-1(c)(1).

77. I.R.C. § 924(d)(1)(B), (d)(2).

78. *See* Treas. Reg. § 1.924(d)-1(c)(1).

payment, and credit risk assumption.⁷⁹ Once identified, then the foreign direct cost activity test is met if either 50% of all these costs are foreign or 85% of any two of the five cost activities are foreign.⁸⁰

One must ask why a U.S. corporation would consider establishing an FSC in a foreign jurisdiction given the rather onerous qualification and export sales requirements. In a nutshell, the earnings of the FSC can be partially exempt from U. S. tax and most, if not all, dividends distributed to the U.S. parent corporation from the FSC qualify for a 100% dividends-received deduction.⁸¹ Thus, FSCs operate as a partial exemption from U.S. tax for U.S. parent corporations on the foreign trading gross receipts, thereby shielding its export profits and promoting export sales.

To better understand the true nature of this exemption, the transfer pricing rules need to be addressed. A transfer price is the price charged by one segment of a company to another segment.⁸² There are three generally accepted transfer pricing methods: cost,⁸³ market⁸⁴ and negotiated.⁸⁵ The most popular pricing method⁸⁶ is market-based transfer prices because it allows for a profit determination by the transferor entity and facilitates a decentralized form of organizational structure.⁸⁷ Nevertheless, the objectives inherent in transfer pricing at the multinational level are significantly different from their domestic counterpart. Domestic objectives include greater divisional autonomy and motivation for managers, coupled with stronger goal congruence.⁸⁸ International transfer pricing objectives focus almost entirely on tax minimization policies with consideration for foreign exchange risks and stronger

79. I.R.C. § 924(e).

80. See I.R.C. § 924(d)(1)(B), (d)(2). See also F. Jan Carnevale & Robert S. Giusti, *FSC Regulations: Qualifying Transactions, Foreign Presence, Foreign Management and Foreign Economic Process Requirements*, 16 TAX MGM'T INT'L J. 175 (1987).

81. I.R.C. §§ 921, 925.

82. See generally, Ralph L. Benke & James D. Edwards, *Transfer Pricing Techniques and Uses*, 61 Mgmt. Acct. 2, 44-46 (1980).

83. *Id.*

84. *Id.*

85. *Id.*

86. For an excellent survey of pricing methods by industrial companies, see Tang, *Transfer Pricing in the 1990s*, 73 Mgmt. Acct. 22, 25 (1992).

87. See FORBES, *supra* note 1.

88. A. Aldsllah, *Guidelines for CEOs in Transfer Pricing Policies*, 70 Mgmt. Acct. 3, 61 (1988).

competitive market positions.⁸⁹

The transfer pricing rules for FSCs, unlike DISCs, allow for *less* income to be allocated,⁹⁰ primarily because of the FSC exemption and the dividends-received deduction tax regime. Under the DISC provision, § 482 allowed the Treasury Department to allocate prices and income between the DISC and its parent corporation.⁹¹ The FSC tax regime allows for either § 482 allocations of income by the Treasury Department or a formulaic approach known as the administrative pricing rules.⁹²

In the case of a sale of export property to an FSC by a related supplier, income is to be allocated to FSCs under one of three methods. One of these methods uses the prices actually charged between the FSC and the "related supplier" (i.e., the United States parent), subject to the standard United States transfer pricing rules in § 482. The other two methods are "administrative pricing" rules, under which FSCs and their parents are allowed to apply for the allocation of income between them.⁹³

The first administrative pricing rule apportions 23% of the total combined taxable income (that is, net income earned by the related supplier and the FSC together) derived from the sale of export property by the FSC and the remaining 77% to its related supplier. This rule further provides that 15/23 (approximately 65%) of the FSC's foreign trade income is exempt from U.S. tax.⁹⁴ Thus, this rule provides an exemption for 15% (23% x 15/23) of the total combined taxable income earned in the transaction.

The second administrative pricing rule allows the FSC to take 1.83% of the total foreign trading gross receipts from the sale of export property as foreign trade income, not to exceed twice the amount allocable to the FSC under the combined taxable income method, i.e., 46% of the total combined (net) income earned in FSC transactions.⁹⁵ This rule further provides that 15/23 (approximately 65%) of the FSC's foreign trade income is exempt from U.S. tax. Thus, this rule provides an exemption for up to 30% (46% x 15/23) of

89. *Id.*

90. The combined taxable income and gross receipts allocated to the FSC are only 23% and 1.83%, respectively. Compare I.R.C. § 994 with I.R.C. § 925.

91. I.R.C. § 994.

92. See I.R.C. §§ 921, 925.

93. I.R.C. § 925(a)(1), (a)(2), (c).

94. I.R.C. §§ 923(a)(3), 921(a)(4).

95. I.R.C. § 925(d).

the total combined taxable income earned in the transaction. This 30% exemption is only available, however, in limited circumstances. Because the ceiling for the gross receipts method is linked to the combined taxable (net) income method, it is not mathematically possible to receive the full 30% exemption unless the profit margin on a transaction is 4% or less. At a profit margin of 8% or more, the exemption amount under the gross receipts method will be no more than 15% under any circumstances.⁹⁶ The following table summarizes these pricing rules:

<i>Method</i>	<i>Target Pricing Rule</i>	<i>Allocation Standard</i>
I	I.R.C. § 482	Arms length market price (30% FTI exempt).
II	Administrative	23% CTI to FSC/77% to related supplier.
	I.R.C. § 923(a)(3)	65.22% FTI exempt for a total exemption of 15% CTI.
III	Administrative	1.83% FTGR, limited twice by the I.R.C.
	I.R.C. § 925(d)	§ 923(a)(3) standard, i.e., up to 46% CTI. This standard allows 46% of the 65% FTI exemption or a maximum exemption of 30% CTI in limited circumstances (see above).

The following example illustrates how economically advantageous the FSC tax regime can be to a U.S. corporation:

A United States-based manufacturing company establishes an FSC pursuant to § 922 in a qualified jurisdiction. It then, as a related supplier, sells its products to the FSC which resells, via a paper trail, to buyers abroad. The FSC, in the alternative, could be a mere agent of the U.S. corporation receiving a commission on the sales.

In either case, the goods are produced and shipped directly from

96. See United States – Tax Treatment for “Foreign Sales Corporations,” WTO Doc. WT/DS108/R, at 2-3 (Oct. 8, 1999), available at <http://www.wto.org> (last visited Dec. 1, 2001), reprinted in 39 I.L.M. 173 (2000) [hereinafter Panel Report].

the U.S. based manufacturer to the foreign buyer. The U.S. parent corporation realizes a foreign profit of \$7,000,000, and under the administrative pricing rules (method II above) allocates 23% to the FSC or \$1,610,000, resulting in a tax exemption of 15/23 or 65% of the foreign taxable income or a total exemption of 15%. Thus, of the \$7,000,000 in combined taxable income, only \$5,950,000 is taxable. To wit:

	<i>U.S. Parent</i>	<i>FSC</i>	<i>Total</i>
CTI	\$7,000,000	---	\$7,000,000
Method II			
Allocation			
23% CTI	<\$1,610,000>	\$1,610,000	---
Tax Exemption:			
15/23 (65.22%)			
or 15% CTI	---	<\$1,050,000>	<\$1,050,000>
TI	\$5,390,000	\$560,000	\$5,950,000

Thus, if we assume a 40% Federal tax rate and a 5% State tax rate, the blended tax rate of 45% results in an FSC tax benefit (cash savings) of \$472,500 ($1,050,000 \times .45$). And distribution by the FSC of the exempt earnings qualifies for the 100% dividends-received deduction,⁹⁷ resulting in no tax on such earnings to the U.S. parent.

So the use of the FSC tax regime, and its income allocation rules for target pricing, can negate the use of the § 482 market value (arms-length) rules.⁹⁸ And since the objective in the selection of an income allocation method is to allocate the largest amount of income to the FSC in order to maximize its tax exemption, generally the administrative pricing regime achieves this purpose.⁹⁹ With such

97. I.R.C. § 921(d). Such income is taxed as effectively connected United States-source income and comes first from qualified foreign trade income. See I.R.C. § 926(a).

98. Treas. Reg. § 1.925(a)-1T(a)(1).

99. The administrative pricing rules allow an exclusion of 15/23 of the foreign trade income (16/23 if the shareholders of the FSC are individuals, which is unlikely considering that no dividends-received deduction is available to them resulting in the taxation of the distributed exempt earnings of the FSC). In contrast, § 482 only permits an exclusion of 30% of the foreign trade income (32% in the case of individual shareholders). Thus, as a U.S. corporation with an FSC, it is possible to

admitted economic tax advantages to U.S. corporations, FSCs flourished, attracting the attention of the world trading community.¹⁰⁰

II. Demise of the FSC

A. *Evolution of the World Trade Organization*

During the turbulent period of the 1990s, with unfavorable trade balances for the United States,¹⁰¹ the world community radically altered the international trade organizational structure. At the 1986-1994 GATT Uruguay Round of Multilateral Trade Negotiations, the World Trade Organization (WTO) was born.¹⁰²

Designed to administer trade agreements, act as a forum for trade negotiations and review national trade policies, its dispute settlement authority is, perhaps, the most significant development.¹⁰³ Built upon the GATT Dispute Settlement System,¹⁰⁴ the WTO Dispute Settlement System is far more structured with timetables and specific procedures.¹⁰⁵ While the system resembles a tribunal, its mission is to promote conciliation and consultation between or among the member nations.¹⁰⁶ An even more significant development

exclude from the FSC's income 15/23 or 65% of the foreign trade income and, upon distribution, pay no tax upon receipt because of the dividends-received deduction. See IRC § 923(a)(3), (a)(2); Treas. Reg. § 1.923-1T(b)(1); *see also* table in text above.

100. According to the WTO report, there were over 6,000 FSCs in 1999 and the estimated total export stimulus, created by FSCs amounted to \$20 billion. *See* Panel Report, *supra* note 96, at 45-46.

101. For instance, in 1996 there was an unfavorable balance of trade of approximately \$191 billion, yet of that number, the United States had a favorable balance in its exporting of services by \$80 billion. *See* CAMPBELL R. MCCONNELL & STANLEY L. BRUE, *ECONOMICS* 764-65 (14th ed. 1999).

102. *See* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, LEGAL INSTRUMENTS—RESULTS OF THE URUGUAY ROUND 1994, *reprinted in* 33 I.L.M. 1143 (1994).

103. *See* Ernst-Ulrich Petersmann, *The Dispute Settlement System of the World Trade Organization and the Evolution of the GATT Dispute Settlement System Since 1948*, 31 COMMON MKT. L. REV. 1157 (1994).

104. *Id.* at 1195.

105. For more information on the WTO Dispute Settlement System, *see* *Settling Disputes: The WTO's Most Individual Contribution*, at http://www.wto.org/english/thewto_e/whatis_e/tif_e/disp0_e.htm (last visited Dec. 1, 2001). The entire Dispute Settlement Procedure takes approximately one year—fifteen months if the dispute is appealed. *Id.*

106. If consultations fail, a “panel” established by the Dispute Settlement Body (DSB) launches into an examination, via an expert review group, culminating in a panel report issued to the parties. Approximately nine months after the panel’s

is that the WTO rules prevented countries from being able to block adverse panel and appellate reports through a lack of unanimity (as was the case under the GATT procedure).¹⁰⁷

B. WTO Panel Report

Still smarting from trade dispute defeats under the trade rules,¹⁰⁸ European Union (EU) member states seized upon the new WTO procedures to challenge the FSC tax regime.

After mandated consultations failed,¹⁰⁹ the EU countries and the challenged party, the United States, argued before the dispute settlement panel of the WTO. The EU claimed, *inter alia*, that there were two significant problems with the FSC tax regime: the FSC was a prohibited export subsidy¹¹⁰ and the administrative pricing rules violated the Agreement on Subsidies and Countervailing Measures (ASCM).¹¹¹

establishment, the report is circulated to the DSB and, if the parties desire, an appellate review of the panel report is granted. This review is not *de novo* but must raise specific points of law. Such appellate review is generally completed within thirty days resulting in an appellate report to the parties and the DSB. Consequently, the DSB has the power to accept or reject the appellate report with the latter requiring a consensus of the DSB—a rare occurrence. Once the panel/appellate report has been adopted, the arduous process of implementation commences with the losing party filing a proposed implementation report within a reasonable period of time. *See* Settling Disputes, *supra* note 105.

107. Richard O. Cunningham & Clint N. Smith, *Section 301 and Dispute Settlement in the World Trade Organization*, in *THE WORLD TRADE ORGANIZATION: THE MULTILATERAL TRADE FRAMEWORK FOR THE 21ST CENTURY AND U.S. IMPLEMENTING LEGISLATION* 581 (Terrence P. Stewart Ed., 1996).

108. *See, e.g.*, EC Measures Affecting Meat and Meat Products (Hormones), Report of the Panel, WTO Doc. WT/DS26/R/USA (Aug. 18, 1997), *available at* <http://www.wto.org> (last visited Dec. 1, 2001).

109. The initial challenge by the EU (the EU comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, and the United Kingdom; Canada and Japan made third-party submissions in support of the EU position.) was on November 18, 1997, seeking consultation with the United States on I.R.C. §§ 921-927 (FSCs). Such consultations failed, so on July 1, 1998, the EU requested that a panel be established. On September 22, 1998, the WTO Dispute Settlement Body appointed a panel wherein the original contentions and arguments were made. *See* Panel Report, *supra* note 96, at 1.

110. *Id.* at 49-51.

111. *See* Agreement on Agriculture & Agreement on Subsidies and Countervailing Measures (ASCM), April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, LEGAL INSTRUMENTS—RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS 6, 39, 264, *reprinted in* 33 I.L.M. 126 (1994); *see* Panel Report, *supra* note 96, at 41-46.

The EU countries argued that the FSC scheme was a subsidy,¹¹² or more specifically, that the FSC tax regime created *two* subsidies. To wit:

The first is the *tax exemptions* comprised in the FSC scheme. These are essentially:

- The exclusion of the “foreign trade income” of FSCs from the controlled foreign corporations provisions of Subpart F of the IRC (Sections 951(e) and 954(d) and (e) IRC);
- The exemption from U.S. tax which would otherwise be due on the “exempt foreign trade income” of the FSC (Section 921(a) IRC).
- The fact that the parent of the FSC is accorded a 100 % dividends received deduction (i.e., exemption from U.S. tax) for the dividends received from the FSC from “earnings or profits attributable to foreign trade income” (Section 245 (c) IRC in conjunction with Section 926 (a)).

These exclusions, exemptions and deductions (hereafter referred to as the “tax exemptions”) complement each other and lead, as they are intended to lead, to less tax being paid than would be the case if the FSC scheme did not exist (or rather if it did not contain the tax exemptions).

The tax exemptions by themselves would be of relatively little economic significance if they were not compounded by the existence of the second of the subsidies which the European Communities identifies and objects to. That is availability for the calculation of the exempt foreign trade income of FSCs of special administrative pricing rules which derogate from the transfer pricing rules which would otherwise apply. These increase the non-taxed profits of FSCs and reduce the taxed profits of the parent companies and consequently decrease the tax burden on exports effected under the FSC scheme.

The European Communities makes this distinction between two aspects of the FSC scheme because each would exist in the absence of the other and it is important that both be held to be prohibited subsidies so that both will have to be withdrawn.¹¹³

Of critical impact to this argument is the bare violation of Article

112. See Panel Report, *supra* note 96, at 47.

113. *Id.* at 47-48.

1 (item (e) of Annex I) of the ASCM, particularly footnote 59:

The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.¹¹⁴

The EU application of this trade rule to the FSC tax regime was clear. It disputed the special administrative pricing rules as being permissible under footnote 59 as well:

As explained above, the FSC scheme exempts part of the FSCs foreign trade income from United States tax, and exempts the dividends arising out of that income from tax in the hands of the parent. The subsidy arising out of the application of the special administrative pricing rules increases the exemption and is thus in itself also an exemption. In addition the fact that this is to be considered an exemption (or perhaps a remission) of direct taxes is confirmed by footnote 59 to item (e) which states that "the Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length." As explained, the FSC special administrative rules do not comply with the arms length principle and are a derogation from it designed to shift profits from export sales into a tax exemption.

Both the tax exemptions per se and the special administrative rules are "specifically related to exports" since they are conditional upon

114. *Id.* at 280.

exportation of United States goods and limited in scope to the extent of such exportation.¹¹⁵

Faced with a statutory conundrum, the United States contended in its arguments that the issues were not so narrowly drawn as the EU described.¹¹⁶ Rather, in the 1990s and beyond, the issue was one of international law and tax sovereignty.¹¹⁷

There is no rule of international law that requires nations to conform to a single tax system. A country can have a worldwide system, a territorial system, or a system that incorporates elements of both. In recognition of principles of tax sovereignty, a country using the worldwide system is free to incorporate elements of a territorial system (or vice versa), so that a foreign subsidiary, or particular kinds of foreign subsidiaries, such as a FSC, are taxed in a manner similar to foreign corporations under a territorial system (exemption of income plus an exemption for dividends) or are taxed like a foreign branch might be taxed under a territorial system (exemption).

The WTO never was intended (and is not well equipped) to establish international tax norms, especially when there is such diversity in accepted tax practices. The WTO certainly should not penalize a country using a worldwide system for incorporating elements of a territorial system in order to obtain comparable tax treatment. However, that is precisely what the European Communities is asking the Panel to do.¹¹⁸

Contrasting the U.S. direct income tax regime of the FSC with the EU model of direct and indirect value added tax (VAT) taxes, the U.S. posited that indirect taxes (VAT) were refundable under the ASCM schema, rendering a significant economic advantage to the EU countries.¹¹⁹ Moreover, as a defensive maneuver, the United States attacked the EU's interpretation of the ASCM pursuant to footnote 59:

The European Communities makes two basic arguments in support of its claim that the FSC regime constitutes a prohibited export subsidy in violation of Article 3.1(a) of the SCM Agreement. First, the European Communities contends that FSC tax exemption itself

115. *Id.* at 53.

116. *Id.* at 55-58.

117. *Id.* at 55.

118. *Id.*

119. *See* ASCM, *supra* note 111, at art. 1.1.

is a prohibited export subsidy. Second, the European Communities alleges that the FSC administrative pricing rules provide an additional export subsidy because they allegedly decrease the tax burden that otherwise would be imposed, presumably by allocating too much income to the FSC. The first is an incorrect proposition as a matter of law; the second is both legally flawed and wholly unsupported by facts.

The United States first responds to the European Communities' first argument – that the FSC partial tax exemption is an export subsidy. This position is untenable, as a matter of law, because it ignores the specific provision of the SCM Agreement that contains the controlling legal standard applicable to its claim – Footnote 59 and the GATT subsidy principles it embodies. Footnote 59 confirms that income generated from economic activity outside the territory of the taxing authority need not be taxed, and that a decision not to tax such income is not a prohibited subsidy. This principle, which dates back to the GATT's original ban on export subsidies and which is articulated in the authoritative 1981 decision of the GATT Council, makes clear that such a tax exemption does not violate Article 3.1(a). The FSC was expressly designed to exempt income derived from foreign economic activities. Because it does so, it is entirely consistent with WTO standards and principles.

Then the United States addressed the EU's second claim—that FSC administrative pricing rules separately conferred a prohibited subsidy by improperly shifting, or misallocating, income.

First, as a legal matter, the European Communities misconstrues the governing provision of the SCM Agreement and builds its entire argument on that erroneous premise. Footnote 59, the applicable provision of the SCM Agreement, provides that WTO Members may allocate income from export transactions in order to distinguish income derived from economic activities outside their territory from income derived from economic activities within their territory. Footnote 59 clearly provides that in making such allocations, Members are free to use administrative or other practices. Accordingly, Members have considerable discretion in deciding what administrative practices to apply, so long as the overall allocation of income approximates arm's length results and does not result in a "significant saving" of direct taxes in export transactions.

The European Communities misstates this standard and, instead, assumes that a prohibited subsidy exists, by definition, because the

FSC does not perform enough activities itself to earn the income allocated to it under the administrative pricing rules, or because the use of an administrative pricing rule may, in particular transactions, produce results different from the result that Section 482 might yield in the same transaction. This ipso facto argument ignores the fact that the purpose of footnote 59 is to discipline the allocation of income so as not to overstate income attributable to foreign economic activities, and thereby confer a subsidy by exempting income generated from activities occurring within the taxing authority's territory. By alleging simply that in particular transactions administrative rules yield prices that are different from those that would result were those rules not available, the European Communities misses both the point of footnote 59 and the point of what the FSC provisions, including its administrative pricing rules, are intended to do.¹²⁰

Despite its efforts to demonstrate the fallacy of the arguments posed by the EU, the Dispute Settlement Panel of the WTO decided, *inter alia*, that the FSC tax regime was indeed an export subsidy in violation of the ASCM:

In our view, the status of the FSC exemptions as an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement is confirmed by item (e) of the Illustrative List. It will be recalled that Article 3.1(a) includes the export subsidies "illustrated in Annex I", i.e., the Illustrative List of Export Subsidies. Under item (e) of the Illustrative List, the following is an export subsidy:

The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.

We consider that the FSC exemptions at issue in this dispute *do constitute* the "full or partial exemption remission, or deferral . . . of direct taxes . . . paid or payable by industrial or commercial enterprises." Second, the exemptions provided under the FSC scheme are in our view "exemptions" within the meaning of item (e) or, in the case of the exemption from the anti-deferral rules of Subpart F, represent the "deferral" of direct taxes. Thus, the U.S. corporate income taxes from which the FSC scheme provides exemptions are "direct taxes" within the meaning of item (e).

We further consider that the FSC exemptions are "specifically related to exports" within the meaning of item (e). In this respect,

120. See Panel Report, *supra* note 96, at 63-64.

we recall our conclusion that the FSC exemptions in question shield from taxation "foreign trading income."¹²¹

The Panel did not adopt the view espoused by the United States that footnote 59 of Article I authorizes a Member to exempt from tax revenue arising from foreign export transactions even if it does not exempt from tax revenue arising from foreign economic processes unrelated to export transactions.¹²² To wit:

[N]owhere, however, does footnote 59 state that "item (e) is not intended to prevent Members from exempting from direct taxes foreign-source income relating to export transactions". The existence of explicit "qualifying" language in footnote 59 regarding deferral and double taxation serves to underline the absence of any explicit statement in respect of the principle which the United States contends may be found in footnote 59. If the Members had desired to exempt from the export subsidy prohibition certain exemptions from direct taxation that were specifically related to exports, they might have been expected to do so explicitly.¹²³

Hence, the Panel found that the FSC tax regime was an export tax subsidy in violation of the ASCM.¹²⁴ The Panel Report is significant, however, for what it did not decide. No decision was made on the all-important issue of whether the administrative pricing rules of the FSC tax regime constituted an export subsidy by their very operation, and whether the 50% domestic content requirement of the FSC tax regime was also an export subsidy.¹²⁵ Since the *entire* FSC tax regime was found to be an export subsidy in violation of the ASCM, Dispute Panel declined to decide these issues, particularly the administrative pricing rule¹²⁶ issue:

In light of our conclusion that FSC exemptions in their totality represent a prohibited export subsidy, and because, in our view, FSC administrative pricing rules perform no role and serve no purpose outside the functioning of those exemptions, we consider

121. *Id.* at 278.

122. *Id.* at 280.

123. *Id.* at 280-81.

124. *Id.* at 287-95.

125. *Id.* at 296-98. At I.R.C. § 927(a)(1)(iii), "export property" is defined, *inter alia*, as not more than 50% of the fair market value attributable to articles imported into the United States. This is the so-called domestic content rule, and any violation thereof excludes the exports from the favorable FSC tax exemption. *See* Treas. Reg. § 1.927(a)-1T(e)(4)(iii)(B) and examples thereunder.

126. Panel Report, *supra* note 96, at 283.

that we have discharged our duty under our terms of reference to make such findings in respect of the European Communities' Article 3.1(a) claims as will assist the DSB in making its recommendations.¹²⁷

In October 1999, as a result of its findings,¹²⁸ the Dispute Settlement Panel recommended to the WTO Dispute Settlement Body that the United States withdraw the FSC subsidies without delay.¹²⁹ It also recommended, inter alia, that the United States bring the FSC scheme into conformity with its obligations with respect to export subsidies under the ASCM.¹³⁰ The time frame set for compliance with the ASCM by the United States was no later than October 1, 2000.¹³¹

C. WTO Appellate Report

Approximately one month after the rendering of the Panel Report, the United States appealed to the Appellate Body of the WTO.¹³² Such review is not de novo and is final for the parties.¹³³

On appeal, the United States raised the following issues:

- (a) [W]hether the Panel erred in finding that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the SCM Agreement, including whether the Panel erred in finding that the FSC measure involves a "subsidy" under Article 1.1 of the SCM Agreement;
- (b) whether the Panel erred in its interpretation and application of Article 3.3 of the Agreement on Agriculture, in particular:
 - i. in its interpretation and application of the term "costs of marketing" in Article 9.1(d) of the Agreement on Agriculture; and
 - ii. in its interpretation and application of the words "shall not provide such subsidies" in Article 3.3 of the Agreement on

127. *Id.*

128. *Id.* at 293-94.

129. *Id.* at 294.

130. *Id.*

131. *Id.* at 295.

132. See B. Whiskeyman, *U.S. Resubmits Appeal with WTO in Foreign Sales Corporation Dispute*, 228 Daily Tax Rep. (BNA), at G-3 (Nov. 29, 1999).

133. See generally note 106, *supra*. Unlike common law tribunals, the Appellate Body of the WTO is *not* bound by precedent. See Cunningham & Smith, *supra* note 107, at 587.

Agriculture.

(c) whether the Panel erred in its interpretation and application of Article 4.2 of the SCM Agreement;

(d) whether the Panel erred in its interpretation and application of footnote 59 of the SCM Agreement by declining to dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules until the European Communities had attempted to resolve this matter through the facilities of existing bilateral tax treaties or other specific international instruments;

(e) whether the Panel erred in finding that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(a) of the SCM Agreement relating to the FSC administrative pricing rules;

(f) whether the Panel erred in finding that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(b) of the SCM Agreement.¹³⁴

In its relatively terse opinion, the Appellate Body did not recognize any merit to the appellant's (United States') argument that footnote 59 of Article 1.1 of the ASCM excludes tax regimes like the FSC:¹³⁵

[E]ven if footnote 59 means—as the United States also argues—that a measure, such as the FSC measure, is not a prohibited export subsidy, footnote 59 does not purport to establish an exception to the general definition of a “subsidy” otherwise applicable throughout the entire SCM Agreement.¹³⁶

In affirming the WTO Panel Report, the Appellate Body decided, *inter alia*, that:

(a) the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the SCM Agreement;

....

(d) the United States acts inconsistently with its obligations under Articles 10.1 and 8 of the Agreement on Agriculture by applying export subsidies, through the FSC measure, in a manner which results in, or which threatens to lead to, circumvention of its export

134. Appellate Panel Report, *supra* note 10, at 25.

135. *Id.* at 32.

136. *Id.*

subsidy commitments with respect to both scheduled and unscheduled agricultural products;

....

(f) it declines to examine the Panel's denial, in paragraph 7.22 of the Panel Report, of the request by the United States that the Panel dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules pending recourse by the European Communities to the facilities of an appropriate tax forum;

(g) it declines to examine the Panel's finding, in paragraph 7.127 of the Panel Report, that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(a) of the SCM Agreement relating to the FSC administrative pricing rules. . . .¹³⁷

Thus, like its predecessor Panel Report, the WTO Appellate Report expressly declined to decide whether the FSC tax regime administrative pricing rules and 50% domestic content requirement were in violation of the export subsidy rules set forth in the ASCM.¹³⁸ So in February 2000, the United States was faced with an ultimatum: follow the WTO recommendations and modify its FSC tax regime to cast it within the acceptable trade rules of the ASCM, or face trade sanctions after failing to reach a mutually acceptable compensation agreement with the EU members.¹³⁹

From a pure tax standpoint, it was clear in the Appellate Report that whatever the United States devised to respond to the export subsidy charge, it had to address both reports' concerns that the FSC tax regime resulted in a reduction of revenues "otherwise due."¹⁴⁰ This is the "but for" test application in the Panel Report (and affirmed in the Appellate Report): "but for" the FSC scheme, the foreign trade income would not benefit from deferral.¹⁴¹ Thus, in the absence of the FSC scheme, the U.S. parent corporation would be required to pay taxes on dividends made out of the earnings and profits attributable to the FSC's foreign trade income.¹⁴² This point

137. *Id.* at 59-60.

138. *Id.* See also Stanley I. Langbein, *International Decision: United States – Tax Treatment for "Foreign Sales Corporations,"* 94 AM. J. INT'L. L. 546 (2000).

139. See Settling Disputes, *supra* note 105, at 6.

140. See Panel Report, *supra* note 96, at 275.

141. *Id.*

142. *Id.*

was conceded by the United States.¹⁴³

It appeared, therefore, that to reach a viable solution the United States had to address the “but for” test within the context of the FSC tax regime granting a subsidy levied as a direct (versus indirect) tax and the benefit bestowed on exports.¹⁴⁴ After a collaborative effort,¹⁴⁵ the United States advanced a proposal to the WTO on May 2, 2000, which was as radical as it was creative. In essence, it had to develop a trade-off tax regime that balanced the trade benefits displaced by the defunct FSC regime against compliance with the WTO Panel Report. That proposal was the new Eligible Foreign Corporation¹⁴⁶ which, as will be seen, failed to satisfy the WTO.

III. The FSC Repeal and Extraterritorial Income Exclusion Act of 2000

A. Abortive Efforts: The Eligible Foreign Corporation

Some few months after the WTO found the FSC tax regime to be an export subsidy in violation of the ASCM, the United States proposed a repeal of the FSC legislation and creation of an eligible foreign corporation (EFC).¹⁴⁷ The EFC had its debilities. It preserved the 50% domestic content requirement and the special administrative pricing rules (now referred to as “formulary pricing”) of the FSC regime.¹⁴⁸ All manufacturing income of U.S. corporations

143. *Id.*

144. See note 138 *supra*.

145. Numerous private sector companies sought to offer proposals and alternatives. See, e.g., *Testimony Before the House Committee on Ways and Means, Hearing on Impact of U.S. Tax Rules on International Competitiveness*, 105th Cong. 1st Sess. (1999) (statement of Sally A. Stiles, International Tax Manager, Caterpillar Inc.), available at 1999 WL 458249 [hereinafter Stiles]; see also *Testimony Before the House Committee on Ways and Means, Hearing on Impact of U.S. Tax Rules on International Competitiveness*, 105th Cong. 1st Sess. (1999) (statement of Kevin Conway, Vice President, Taxes, United Technologies Corp. and Vice Chairman, International Tax Subcommittee, National Association of Manufacturers), available at 1999 WL 458271 [hereinafter Conway].

146. See FDTA Hot Issues: U.S. Proposes FSC Replacement Legislation, at 1 (May 2, 2000), at <http://www.fdta-cite.org/hot>.

147. *Id.*

148. See FDTA Hot Issues: EU Cries “Foul” over the U.S. FSC Alternative Tax Proposal, at 1 (May 26, 2000), at <http://www.fdta-cite.org/hot>.

was subject to the reduced marginal tax rate of 29%.¹⁴⁹ But unlike the FSC regime, the U.S. parent could elect to treat all entities, foreign *and* domestic (including controlled foreign corporations), as an EFC, subjecting its earnings to the preferential rate.¹⁵⁰ Hence, it was an elective tax regime proposal that applied across the board to export and non-export sales.¹⁵¹

Unfortunately, the Chairman of the EU Commission found the proposed EFC regime to be defective¹⁵² because, like its predecessor the FSC, it still owed allegiance to export sales,¹⁵³ maintained the domestic content requirement,¹⁵⁴ and permitted formulary pricing.¹⁵⁵ The EU Chairman was ostensibly correct,¹⁵⁶ but the United States was still saddled with a fast approaching October 1, 2000 deadline. Moreover, a lame duck President was in the White House, who would be exiting within months of the EU rejection. The last thing President Clinton wanted for his international legacy was to be identified in history as the President who started a trade war with America's European neighbors.¹⁵⁷

Finally, on July 27, 2000, the Joint Committee on Taxation presented the House Ways and Means Committee with a bill by that employed an entirely different approach than the failed EFC proposal.¹⁵⁸ It passed the same day.¹⁵⁹ Such was the birth of H.R. 4986.

149. See Stiles, *supra* note 145, at 1.

150. *Id.*

151. See Joe Kirwin, Sindhu G. Hirani & Katherine M. Stimmel, *U.S. Outlines FSC Fix to Europeans, Offers Elective Regime for Foreign Sales*, 86 Daily Tax Rep. (BNA), at GG-1 (May 3, 2000).

152. See FDITA Hot Issues, *supra* note 146, at 1.

153. See Stiles, *supra* note 145, at 1.

154. *Id.*

155. *Id.*

156. See Joe Kirwin & Daniel Pruzin, *Europeans, U.S. Officials to Face Off Following EU Rejection of FSC Proposal*, 105 Daily Tax Rep. (BNA), at GG-1 (May 31, 2000).

157. The interaction of the White House and the House Ways and Means Committee Chairman indicates the level of commitment by the White House and Congress on this point. See, e.g., Ryan J. Donmoyer, "Don't Give Away FSC Store," *Archer Cautions White House*, TAX NOTES TODAY, March 22, 2000, available at 2000 TNT 56-4.

158. JOINT COMM. ON TAXATION, DESCRIPTION OF H.R. 4986 (FSC Repeal and Extraterritorial Income Exclusion Act of 2000), July 27, 2000.

159. See Sindhu G. Hirani, *Ways, Means Oks Proposal to Replace FSC with More Territorial Taxation System*, 146 Daily Tax Rep. (BNA), at GG-1 (July 28, 2000).

B. The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (H.R. 4986)

The clock was ticking. After its passage by the Committee on Ways and Means on July 27, 2000, H.R. 4986 had to wind its way through the Senate Finance Committee, the Joint Conference Committee, House and Senate Floor votes, and the White House—all before the October 1, 2000 deadline. This would be a challenge of no small measure considering the proposed legislation's new "territorial" approach;¹⁶⁰ broadened availability to most U.S. taxpayers (U.S. individuals, domestic C or S corporations, partnerships, branches and other flow-through entities);¹⁶¹ retention of the 50% domestic content requirement and formulary pricing;¹⁶² the lack of foreign corporation, foreign office or foreign management requirements;¹⁶³ and the dividends-received deduction on qualified foreign trade income.¹⁶⁴

In light of the Ways and Means Committee recommendations,¹⁶⁵ the House passed H.R. 4986 on September 13, 2000. Just six days later, however, the Senate Finance Committee reported out a version that differed slightly from H.R. 4986.¹⁶⁶ Nevertheless, with the deadline looming, the EU and the United States reached an accord to extend the October 1, 2000 deadline (to avoid trade sanctions) until November 1, 2000,¹⁶⁷ which was subsequently extended to November 17, 2000.¹⁶⁸ The Senate eventually passed the amended version, which disallowed the dividends-received deduction, on November 1, 2000, and sent it to the House, which subsequently passed the bill on November 14, 2000.¹⁶⁹ Finally, just *two* days before the extended

160. See FDTA Hot Issues: Executive Briefing, at 2, 3 (July 28, 2000), at <http://www.fdta.cite.org/hot>. See also FSC Repeal and Extraterritorial Income Exclusion Act of 2000, *supra* note 158.

161. *Id.* at 3.

162. *Id.*

163. *Id.*

164. See FSC Repeal and Extraterritorial Income Exclusion Act of 2000, *supra* note 158, at 5-6.

165. See Hirani, *supra* note 159.

166. See Robert Goulder, *Senators Urge Consent Agreement for FSC Repeal Bill*, TAX NOTES TODAY, Sept. 25, 2000, at 3, available at 2000 TNT 186-3.

167. See Cordia Scott, *FSC Extension Shows EU's Willingness to Solve Dispute*, TAX NOTES TODAY, Oct. 10, 2000, available at 2000 TNT 196-3; *Senate Presses for Export Tax Overhaul*, Oct. 4, 2000, at <http://www.news.lycos.com>.

168. See Daniel Pruzin, *EU Sets Nov. 17 Date for Retaliation Request If U.S. Fails to Adopt FSC Replacement*, 212 Daily Tax Rep. (BNA), at G-1 (Nov. 1, 2000).

169. See 213 Daily Tax Rep. (BNA), at GG-1, L-1, L-7 (Nov. 2, 2000) for the

deadline expired, President Clinton signed H.R. 4986 into law and on November 15, 2000, an international trade war was narrowly averted.¹⁷⁰ At the signing ceremony President Clinton stated:

particularly legislation in the sensitive field of taxation policy, in order to implement the findings of a dispute settlement panel of the WTO. We believe that this legislation specifically addresses the concerns raised by the WTO Appellate Body and will be found to be WTO-compliant.¹⁷¹

Thus, H.R. 4986, now P.L. 106-519, became the new tax regime creating a unique treatment for export sales. But would it pass the gauntlet of the EU, the WTO recommendations, and the ASCM? This important piece of legislation bears scrutiny to answer this query.

C. The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519)

The alacrity with which the major tax legislation moved through Congress and the White House was mind-boggling.¹⁷² But, as the adage queries, does haste make waste? Within a month of passage, the EU renewed its request for authority to impose sanctions amounting to over \$4 billion annually.¹⁷³ Pursuant to WTO procedures, the EU and the United States held consultations on P.L. 106-519. The consultations failed,¹⁷⁴ and the EU requested the establishment of a WTO compliance panel to assess whether the new legislation was WTO consistent.¹⁷⁵ Coterminous with the panel's appointment was the suspension of the \$4 billion trade sanctions until

Senate vote and 221 Daily Tax Rep. (BNA), at GG-1, GG-2, GG-3 (Nov. 15, 2000) for the House vote.

170. See *FSCS: Clinton Signs Bill Replacing FSC Regime* 223 Daily Tax Rep. (BNA), at GG-1 (Nov. 17, 2000). It applies to transactions after September 30, 2000, but allows for FSCs in existence prior to that date to continue to operate for all transactions entered into before January 1, 2002 and all transactions under a binding contract in effect on September 30, 2000. See 26 U.S.C.A. § 941(5)(c).

171. *Id.*

172. When one considers that the original H.R. 4986 was tendered by the Joint Committee on Taxation in late July, 2000, and a final comprehensive piece of tax legislation repealing seven Code sections and substituting an entirely new international tax regime was enacted in early November, 2000, it is quite remarkable.

173. See Talisman, *supra* note 12, at 5.

174. *Id.*

175. *Id.*

resolution.¹⁷⁶ If the compliance panel finds the FSC replacement legislation to be WTO consistent, the matter ends.¹⁷⁷ On the other hand, if it is found to be WTO inconsistent, then the \$4 billion trade sanctions may become operative subject to a WTO arbitration panel.¹⁷⁸ The Treasury Department is confident that P.L. 106-519 is neither an export subsidy nor export contingent.¹⁷⁹

To determine whether this is the case, P.L. 106-519 must be examined. It contains, *inter alia*, the following measures:

- Repeal of I.R.C. §§ 921-927 (the FSC provisions);¹⁸⁰
- Special exclusion for extraterritorial income;¹⁸¹
- Election process applicable to a broader category of U.S. persons;¹⁸²
- Special definitions for qualified foreign trading income¹⁸³ and property,¹⁸⁴ foreign trading gross receipts¹⁸⁵ and foreign trading sale and leasing income;¹⁸⁶
- Neither credits nor deductions (including the dividends received deduction) are allowed;¹⁸⁷
- Certain FSC provisions are retained; to wit: domestic content requirement,¹⁸⁸ formulary pricing,¹⁸⁹ and economic process requirements;¹⁹⁰ and
- Liberal treatment of existing FSCs with respect to compliance via the transitional rules.¹⁹¹

The preceding seven measures bear closer scrutiny to determine

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. 26 U.S.C.A. prec. § 921(2).

181. *Id.* § 114.

182. *Id.* § 943(e).

183. *Id.* § 941.

184. *Id.* § 943(a).

185. *Id.* § 942(a).

186. *Id.* § 941(c).

187. *Id.* § 114 (c), (d).

188. *Id.* § 943(a)(1)(C).

189. *Id.* § 941(a)(1)(A), (B), (C).

190. *Id.* § 942(b).

191. *Id.* § 941(5)(c).

whether the export subsidy label adheres. First, of the significant features of the new legislation, the one most satisfying to the EU, and thus judged WTO compliant, is the provision dealing with the repeal of the FSC §§ 921-927.¹⁹² Clearly the mandate from the WTO Panel Report,¹⁹³ as affirmed in the WTO Appellate Report,¹⁹⁴ was that such a tax regime was an export subsidy and noncompliant with the ASCM.

Second is the measure creating a special exclusion for extraterritorial income.¹⁹⁵ In drafting an entirely new § 114, Treasury created a *new* benchmark for taxing income from sales outside the United States by providing that gross income specifically excludes extraterritorial income, provided such income is “qualifying foreign trade income.”¹⁹⁶ Consistent with that treatment, as discussed below, no “double dipping” is allowed, i.e., no deductions or credits are permitted against such repatriated and distributed income.¹⁹⁷ Of greater significance, however, is that the exclusion under new § 114 applies to *both* the regular tax and the alternative minimum tax¹⁹⁸ for the affected U.S. taxpayer.¹⁹⁹

Third is the election process. To receive the exclusion a *single* entity approach²⁰⁰ is employed unlike the FSC regime, which mandated that a separate affiliate be used for the exclusion. It is also more inclusive in that the exclusion is available to more U.S. taxpayers, i.e., individuals, domestic C or S corporations, partnerships, branches and other conduit or flow-through entities.²⁰¹

192. See 26 U.S.C.A. prec. § 921(2).

193. See Panel Report, *supra* note 96, at 294.

194. See Appellate Panel Report, *supra* note 10, at 59-60.

195. See 26 U.S.C.A. prec. § 114.

196. *Id.* § 114(a), (e).

197. *Id.* § 114(c), (d).

198. See, e.g., *supra* note 158, at 5. The individual and corporate alternative minimum tax can be particularly onerous because it can place taxpayers in the position of a substantial tax liability despite the fact that little or no regular tax liability occurs. To review how this process works, see HAROLD S. PECKRON, PLANNING AND WORKING WITH THE ALTERNATIVE MINIMUM TAX pts. I, II, IV (1991 Supp.).

199. See 26 U.S.C.A. prec. § 114(a), (e).

200. This approach substantially mitigates the EU’s argument under the FSC tax regime, though never decided by the WTO trial or appellate panels, that the transfer pricing or administrative pricing rules were a form of subsidy. Here it is theoretically impossible to “allocate” income when only a *single* entity is involved. See notes 82 and 99, *supra*.

201. See *supra* note 158, at 5.

Even shared entities are permitted, as is the case with shared partnerships.²⁰² Hence, the exclusion principle of new § 114 and the election process by a single entity to treat qualifying foreign trade income as excludable income addresses the WTO concern that there is no foregone (deferred) revenue²⁰³ and thus, no subsidy.

This is buttressed by the nature of the election. Even certain foreign corporations, e.g., former FSCs or controlled foreign corporations, may elect to be treated as domestic corporations,²⁰⁴ provided the electing corporation foregoes any U.S. treaty concessions and either manufactures property in the ordinary course of its business or substantially all of its gross receipts are foreign trading gross receipts.²⁰⁵ Such election, once terminated or revoked, cannot be made again for up to five years.²⁰⁶ Consequently, the second and third provisions should be viewed as WTO compliant and acceptable to the EU.

Fourth are the special definition sections of qualified foreign trading income and property, foreign trading gross receipts, and foreign trading sale and leasing income.²⁰⁷ If there is an Achilles heel in the new legislation for WTO compliance, this may be it. How narrowly the specific terms are defined may be the determining factor for the WTO compliance panel.²⁰⁸

In order to qualify for the blanket exclusion, a U.S. taxpayer must have qualifying foreign trade income,²⁰⁹ which is the umbrella term to include foreign trading gross receipts,²¹⁰ foreign trade income,²¹¹ and foreign sale and leasing income.²¹² Qualifying foreign trade income is the amount of the taxpayer's gross income that, if excluded pursuant to new § 114, would result in a reduction of taxable income by the greatest of:

- A. 30% of the foreign sale and leasing income derived by the taxpayer from such transaction,

202. 26 U.S.C.A. § 943(f).

203. *See supra* note 121.

204. 26 U.S.C.A. § 943(e).

205. *Id.* at § (e)(2).

206. *Id.* at § (e)(3)(C).

207. *See* 26 U.S.C.A. prec. §§ 941, 941(a), 942(a), 943(a).

208. *See generally*, Talisman, *supra* note 12.

209. *See* 26 U.S.C.A. prec. § 941.

210. *See supra* note 185.

211. *See supra* note 183.

212. *See supra* note 186.

- B. 1.2% of the foreign trading gross receipts derived by the taxpayer from the transaction, or
- C. 15% of the foreign trade income derived by the taxpayer from the transaction.²¹³

Note that these three rules are equivalent to the “hexed” administrative pricing rules condemned by the EU²¹⁴ (albeit the WTO Panels did not decide whether such rules were a species of the export subsidy).

Would the adoption of the FSC tax regime’s administrative pricing rules be the death knell for the new legislation? Perhaps not. The strenuous objection by the EU went to the allocation preference accorded the income between the FSC and the U.S. corporation.²¹⁵ Such is not the case here with a single entity. The only purpose these formulary rules obtain is to allow income allocations within the single entity—a purpose that should be far less objectionable to the EU.

At the heart of the qualifying foreign trade income is the definition of foreign trade income,²¹⁶ which means the taxable income of the taxpayer attributable to foreign trading gross receipts of the taxpayer.²¹⁷ Hence, the crucial definition becomes foreign trading gross receipts,²¹⁸ which turns upon the classification of the source of such receipts, viz., qualifying foreign trading property.²¹⁹ To wit:

(1) In General,—the term ‘qualifying foreign trade property’ means property –

- A. manufactured, produced, grown, or extracted within or outside the United States,
- B. held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
- C. not more than 50% of the fair market value of which is attributable to –
 - i. articles manufactured, produced, grown, or extracted

213. 26 U.S.C.A. § 941(a)(1)(A), (B), (C).

214. *See supra* notes 94, 95 and 96.

215. *See supra* note 115.

216. 26 U.S.C.A. § 941(b).

217. *Id.* at § (b)(1).

218. *See supra* note 185.

219. *See supra* note 184.

outside the United States, and

- ii. direct costs for labor (determined under the principles of section 263A) performed outside the United States.²²⁰

Once again, the 50% domestic content requirement of the FSC tax regime is preserved under this definition but it *is* modified to allow manufacture to include outside the United States, provided the 50% threshold is maintained. This could be a point of resistance with the EU countries but, if viewed in the larger vista of world trade, should be permissible. As with the administrative pricing rules, the WTO trial and appellate bodies declined to decide whether the domestic content requirement was tantamount to an export subsidy.²²¹

Arguably the "foreign economic processes" support the finding that foreign trading gross receipts can originate only from certain economic processes *outside* the United States.²²² The saving grace is that there is no longer a requirement that production *must* be in the United States. Thus, 100% of the production can be overseas, as in foreign direct investment cases,²²³ provided that the 50% domestic content requirement is satisfied in those foreign-made goods.²²⁴

Another concern is whether the foreign sale and leasing income, which generates foreign trade income, is similar, like foreign trading gross receipts, to the criteria necessary for the FSC regime.²²⁵ Foreign sale and leasing income is the amount of the taxpayer's foreign trade income that is allocated to activities constituting foreign economic processes or income from the leasing of qualifying foreign trade property.²²⁶

As for this fourth measure, the EU disgust with the FSC tax

220. 26 U.S.C.A. § 943(a)(1).

221. See Langbein, *supra* note 138.

222. 26 U.S.C.A. § 942(b).

223. Foreign direct investments exhibit greater complexity and risk than domestic ventures; yet, such investments actually lower the portfolio risk of the U.S. taxpayer by stabilizing the combined operating cash flows for the U.S. multinational corporation. This risk reduction occurs because the two economies, foreign and domestic, have less than perfect correlation. See STANLEY B. BLOCK & GEOFFREY A. HIRT, *FOUNDATIONS OF FINANCIAL MANAGEMENT* 593 (8th ed. 1997).

224. 26 U.S.C.A. § 943(a)(1)(C). An elective American manufacturer in Belgium that uses at least 50% American parts to manufacture and assemble a product that is sold in Europe is an example of this rule.

225. See *supra* note 158, at 6.

226. 26 U.S.C.A. § 941 (c), (1), (2).

regime on foreign sales should not extend to the new legislation because the definitional treatment of foreign sales is consistent with the WTO decision, meaning that a U.S. taxpayer obtains the same tax benefit on foreign sales regardless of their point of manufacture, whether in the United States or overseas.²²⁷ Such consistency should appease the EU since the foreign sales are *not* export contingent and should be found ASCM consistent by the WTO compliance panel.

Fifth is that neither tax credits nor tax deductions are allowed under the new legislation.²²⁸ Unlike the FSC regime, no dividends-received deduction is allowed to the U.S. corporation.²²⁹ This treatment should present no problem to the EU since it resolves a bone of contention under the FSC tax regime.²³⁰

Sixth, as discussed earlier, the retention of the 50% domestic content rule (mitigated by the carte blanche overseas production rule), formulary pricing (negated by the single entity requirement), and the economic processes requirement (relaxed by the overseas production rule) should be considered far less objectionable to the EU as they cure FSC deficiencies. Such treatments appear consistent with the letter and spirit of Article 3.1 and particularly footnote 59 of the ASCM in describing an export subsidy.²³¹

Last is the recognition that the retroactive effective date²³² of the legislation, after September 30, 2000, could adversely impact U.S. taxpayers with existing FSCs. So, transition rules had to be adopted that recognized this fact. In the instant case, these rules can only be characterized as rather liberal.²³³ Thus, any FSC in existence before September 30, 2000, could continue as an FSC for any transactions arising before January 1, 2002²³⁴ and all transactions arising from a binding agreement in effect on September 30, 2000.²³⁵ Also U.S.

227. See 26 U.S.C.A. prec. §§ 941, 942(a), 943(a).

228. *Id.* § 114(c), (d).

229. This was the so-called Grassley amendment to H.R. 4986, which specifically denied the dividends received deduction to U.S. corporations on qualifying foreign trade income. See *Senators Urge Consent Agreement for FSC Repeal Bill*, Sept. 25, 2000, available at 2000 TNT 186-3.

230. See Panel Report, *supra* note 96, at 47-48.

231. *Id.* at 280.

232. The bill (H.R. 4986) was signed into law on November 15, 2000, but was retroactively effective on transactions occurring after September 30, 2000, to comply with the original WTO deadline of October 1, 2000.

233. See 26 U.S.C.A. § 941(5)(c).

234. *Id.* § 941(c)(1)(A).

235. *Id.* § 941(c)(1)(B).

taxpayers with existing FSCs can always elect to have the new legislation apply.²³⁶ These provisions would be construed as mere administrative matters and should not strike at the heart of the compliance issue for the WTO.²³⁷

When all seven measures in the new legislation are considered, it appears that none, standing alone, would be sufficient to derail this most recent effort to comply with the WTO recommendations. Since the EU has indicated its unwillingness to accept this effort by requesting a WTO compliance panel²³⁸ after consultations proved fruitless, the outcome bears watching. But what tax policy implications arise from this new approach at extraterritorial taxation? Some undaunting challenges to international tax policy appear to surface.

IV. International Tax Policy Implications

Tax policy is the government's attitude, objectives and actions which reflect normative standards that the government deems most important.²³⁹ Public Law 106-519, the new tax regime of extraterritorial exclusion of qualifying foreign trade income by U.S. persons, represents a major watershed in international tax policy. This is because of the dramatic shift that it draws from the taxation of worldwide income to the taxation of income within a discretely defined territorial region.²⁴⁰ Thus, taxation has long been a worldwide concept in the United States including all income from whatever source derived,²⁴¹ at least until the prodigious step of the new legislation. And yet, *limitations*²⁴² to the general rule clearly abound, as with nonresident alien individuals.

Territorial taxation, as espoused by P.L. 106-519, ignores the taxpayer deriving the income and instead focuses on income solely within a governmental territory. In essence, foreign income of a

236. *Id.* § 941(c)(2).

237. *See* Settling Disputes, *supra* note 105.

238. *See* Talisman, *supra* note 12.

239. *See* SALLY M. JONES, PRINCIPLES OF TAXATION FOR BUSINESS AND INVESTMENT PLANNING 2000, at 23 (1999).

240. *See supra* note 158, at 5.

241. *See* I.R.C. § 1 (individual) and § 11 (corporation) for the imposition of a direct income tax on which taxable income is the base and is derived from gross income, and I.R.C. § 61, which expressly includes all income from whatever source derived.

242. *See, e.g.,* I.R.C. §§ 2(d), 871, 877, 911(a).

citizen or tax “person” (individual or entity) is ignored. Thus the extraterritorial income exclusion set forth in the new law is territorial taxation for U.S. persons.²⁴³

Another significant policy issue springing forth from the new law is the fact that the U.S. person is an actual taxpaying entity, not a completely artificial entity with no independent business *raison d’être* as in the FSC regime.²⁴⁴ Now corporations will use an operational entity that has foreign trade income from foreign gross receipts of foreign trade property. Such a policy shift supports the argument that the new extraterritorial exclusion regime is WTO compliant.

Policy also recognizes that a legitimate tax objective for government is the simplification of tax administration. Thus, the new exclusion significantly reduces the administrative costs attendant to the complexity of qualifying foreign trade income reporting.²⁴⁵ U.S. taxpayers reap a benefit in lower compliance costs through elimination of the alternative minimum tax on such income.²⁴⁶

These policy issues have taken international or worldwide taxation to a new level for U.S. taxpayers. Notwithstanding the WTO compliance panel review, it is clear that the existing extraterritorial exclusion for qualifying foreign trade income will be long recognized as a major contribution to U.S. tax policy.

V. Conclusion

It is interesting to reflect on the aftermath of what appeared to be the avoidance of a trade war. Certainly the uniform trade rules of GATT, ASCM and other procedures were followed, but what of the strategic result? There’s the rub.

Never in its history has the WTO (or its predecessor GATT) dissected a national tax policy on behalf of a protesting trade member.²⁴⁷ While WTO procedures do not recognize precedent,²⁴⁸ it is dangerous nevertheless for the WTO to embark upon such a course. Any member nation fearful of its tax regime being attacked—for purely political motives—will be less inclined to disclose its true

243. See note 240, *supra*.

244. See I.R.C. §§ 921-927.

245. The use of two entities and concomitant transfer pricing rules engenders significant administrative cost and accounting burdens. See notes 63 and 93, *supra*.

246. See note 198, *supra*.

247. See, e.g., Jackson, *supra* note 28.

248. See note 133, *supra*.

tax policies. This, in turn, will lead to misunderstandings and further conflicts, underscoring Justice Brandeis' comment at the beginning of this article.

The purpose of this Article was to examine the FSC tax regime as a catalyst to an international trade war.²⁴⁹ In that regard, the history of international tax policy from 1971 to the present was examined with particular emphasis on the most recent addition to that repertoire, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.²⁵⁰ Its operative provisions were then examined with an eye toward their compliance with the Agreement on Subsidies and Countervailing Measures²⁵¹ of the WTO.

One conclusion arising from this analysis is that the new tax policy enunciated in this law should be WTO compliant while at the same time bringing the United States international tax regimes closer to territorial taxation.²⁵² Only time will tell whether such a major development is a strategic benefit to U.S. taxpayers. But one thing is clear. The exercise of the WTO's judicial discretion in condemning a country's tax regime casts the world community into a position of less, not more, trust and openness on tax policy issues. Perhaps the sage wisdom of a Justice Brandeis will prevail in future export cases at the WTO. If not, the next trade war may indeed be an international economic war.

249. See *U.S. Will Challenge EU's Filing of Sanctions in FSC Dispute; No Immediate Trade War Looms*, Nov. 20, 2000, available at 2000 Tax Day, No. T.1.

250. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000).

251. See note 111, *supra*.

252. See note 241, *supra*.